SOME ASPECTS OF THE ECONOMIC CRISIS

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Abstract
The article comments on some aspects of the present economic crisis. The role of bonuses in a system with principal-agent relationship is discussed. Several other features like the responsibility of rating institutes are considered. A main point is to question our knowledge about the crisis. New developments in economics take soft factors into account. These factors and the fact that at most "bounded rationality" guides human action throw some doubt on ready-to-hand judgments.

Keywords: economic crisis, mortgages, international banking system

JEL Classification: M3, M31, L81

Introduction

The present economic crisis is intensively discussed in newspapers, journals, and internet. All who are concerned follow the discussion; and this is the bulk of the population, the greater part because they are worried about their economic situation, and the smaller part because they bear responsibility. Lots of experts and politicians propose remedies. Unfortunately the recipes are rarely congruent and sometimes even contradictory. Experts, of course, must appear convinced and convincing if they want to become consultants of politicians. Yet we may ask how profound our knowledge about what has happened is.

There is nevertheless much agreement as to the main reasons of the crisis. We will here accept these core features. Less agreement is observed with respect to the details especially with respect to the weight to be put on the different causes, and about what is to do. The striking point, however, is that most of the agreement is ex post; before the crisis hardly anybody was aware of the fatal development. The few who were warning were neglected (Schiller R., 2005). Are there not always some experts who see dangers? The author of this paper has a skeptical attitude and does not pretend to know affairs better than others. Speculation and economic collapses have accompanied mankind through history. They will appear in future, too. The best we can do is to make them less severe. To achieve this a few aspects of the problem are to be discussed in the sequel.

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1. The Genesis of the Crisis

The origin of all the trouble is the US- American housing market. This is certainly only *one* market in *one* specific nation. Yet it is a very big market in the world's largest economy with the international key currency. How could this special market disturb the world economy so deeply? The sequence of events is the following. From about 2002 the US housing market boomed. Prices went up steadily. The belief in permanently increasing prices for real estate in future was widely spread. The boom was fostered by the low-interest-policy of the Federal Reserve Bank (Schiller R., 2008, p.50).

Even those parts of the population who never had thought of living in their own homes took advantage of low credit costs and bought houses. The finance sector made this possible also by lowering the standards for housing credits. The risk of insolvency of borrowers seemed low as long as real estate prices continued their upward rally. So many people received a credit who did not comply with traditional requirements. They formed the subprime sector of mortgages.

In fall 2007 mortgage rates increased. Many new home owners had no fixed mortgages rates. They were not able to pay the higher rates and were driven into insolvency. The result was a great number of foreclosures against home owners (Schiller R., 2008, p.51). As a consequence the supply of homes went up and the prices for housing went down. The bubble burst. The hope of continuing price increases was disappointed. It was not merely the carelessness of banks (that should have known it better) and house owners (who were badly advised) but there were also changes in the economic situation that caused the risks to become reality.

Exactly this happened. The American housing market was driven by a speculative bubble that could not withstand the challenges of the market and finally burst. So far the subprime crisis is a purely American problem. The immediate impact of the American subprime crisis on the rest of the world at least the Western world is, however, the most interesting feature of the event. The impact seems to be even more all-embracing and faster than the proliferation of the Great Depression from 1928 to 1933. One aspect of globalization is demonstrated here. Financing the boom was made easy by the cheap-money policy of the Federal Reserve System. Banks used their existing assets of mortgages to expand.

This is unprecedented in financial history. In a first step the banks sold the mortgages to securitize thus changing them in tradable bonds. Mortgages formed the basis of a manifold of arcane financial products. Not many people did understand them and their risks, least those who bought them. After all subprime mortgages formed an essential part of these papers. In a second step banks used the revenue out of the sales of mortgage-based securities and took additionally cheap money from the market thus using leverage effects to expand the volume of real estate credits. This money again was invested in new mortgages. The procedure was repeated again and again. (Figure no. 1)

Figure no. 1: Anatomy of the bubble

This describes a vicious circle that caused a gigantic volume of credits. We may call it the anatomy of the bubble. Anyway a great number of doubtful papers came into circulation and the public was not informed of their quality. The present discussion has its focus on this lack of information or even misguidance. Finally trustful investors financed the American real estate boom. Among them were not only American investment banks and insurance companies but also investors from around the world. English, French and German banks lost huge amounts of money when the bubble burst. Government intervention in the United States and several European countries prevented the banking systems from collapsing. Hence the taxpayer has to pay.

The crisis is no longer only an American problem. The losses of national speculative bubbles are partly internationalized, again a consequence of globalisation. The rating agencies are criticized for their double function on the one hand as advisers and on the other hand as rating analysts giving top ratings to subprime papers (www.marketoracle.co.uk). The high reputation of these institutes misled the public and deceived customers including banks that looked for profitable investment. During the 2009 election campaign in Germany all parties took up this line of criticism, and postulated the separation of the two functions of rating agencies (***, IWD). It is difficult to belief that professionals in the banking industry were not aware of the fallacies of the system. Nevertheless most of them acted in good faith. They were carried away by a wave of optimism. How far can we trust professionals?

2. Why does the Financial Sector impair the whole Economy?

All these considerations may explain a crisis of the international banking system. Now a question may be raised: How could the banking crises inflict damage on the real economy?

As a consequence of the crisis banks distrusted one another and became reluctant with credits to anybody. This general distrust can explain part of it but not all. There are other reasons, too. The reminiscence of the Great Depression (1928-1933) is still present. The economic problems at that time started also within the financial sector of the United States and spread from there all over the world. A stock crash 1928 marked the beginning of the long-lasting period of low-level economic activity. Most people are now convinced by analogy that again a deep depression is impending presumably less severe and less lasting than the Great Depression since governments will behave – hopefully – more reasonable. Is this really true? Perhaps! Yet we do not really know. Quite a few indicators of the United

States and also of the major European economies suggest that the worst may be over. The decided actions of the economically leading nations to mitigate the crisis have certainly had an effect on the real and on the psychological level. Even more effectual the international cooperation might have proved. Here we observe distinctive differences between the present situation and that during the Great Depression. We do not know, however, to what extent political action has improved the *real situation* and to what extent it has influenced the *atmosphere* and created a more *optimistic attitude*. It is difficult to assess the magnitude of the effects of political action, especially in advance. This is again a gap in our knowledge. These arguments are not as strict as economists like them. They are notwithstanding of some weight. They reveal the psychological dimension of economic beliefs and decisions. Confidence in long-lasting increases of real estate values and pessimism concerning the economic activity of the future has something in common: They represent soft factors influencing hard facts.

Traditional theoretical economists did not deny psychological factors but they neglected them more than is adequate. They preferred to explain the economic world (and parts of it) on the basis of observable phenomena and the overall assumption of rational people ("homini oeconomici"). Practical economists were always aware of soft factors and the successful among them used to draw advantage out of their knowledge (?) or instinct (?). The modern movement of experimental economics tries to find out actual human behaviour as composed of rational and non-rational elements. The idea of a completely rational man who is able to analyse all situations completely is given up because it goes beyond human abilities. A really astute man knows about his deficiencies. He tries to be "reasonable" instead of rational. This is the idea of "bounded rationality" (Simon H.A., 1957). Human decisions are rational as far as the best choice is obvious. Otherwise people follow other rules (e.g. rules of thumb, common practice, heuristics, and instinct). Such a philosophy leaves space for emotional reactions and believes. There are certainly rules behind such behaviour, but it is not easy to find them out. The rules may have a "human component" (valid for human beings everywhere) and a "cultural component" (valid only for members of a specific culture or even social group). The financial sector is a cultural milieu with similar rules all over the world and is by far more unified than other economic sectors. This is so because the financial sector is more internationalized than any other economic sector. Even within the financial sector the image of soberly calculating bankers does not meet reality. Psychological factors are present besides the rational ones. Numerous stock market reports with pictures like "bull market" or "bear market" demonstrate this. It has not been since recently that new insights into human behaviour on a theoretical and empirical level have found their way in more practical discussions. Akerlof and Shiller (Akerlof G.A., Schiller R.J., 2009) use those modern contributions and insights in order to draw the necessary consequences. Traditional economic argumentation neglected the psychological dimension to explain the economic reality. Great economists have often referred to human psychology. So did John M. Keynes when he introduced "animal spirits" as a factor of human economic acting (Keynes J.M., 1973, pp.148-151). Akerlof and Shiller resume Keynes' approach and apply it to practical situations, also to the crisis. We may interpret "animal spirits" here as a compound of soft factors (rules of fairness, rules of behaviour, convictions, instinct, etc.) that are not derived from rational thinking. They also use results of experimental economics. Their concept is actually one of bounded rationality extended even by some elements of irrationality prevailing in the real world. The present crisis inspired them for many comments and discussions (Akerlof G.A., Schiller R.J., 2009, pp.86-89). The argumentation differs greatly from traditional discussions of the problems, and throws much light on the drives behind the financial sector and much doubt on many of our traditional views.

3. Some Theoretical Considerations

One of the key problems in the public discussion around the financial crisis is that of bonuses (derstandard.at). Consider a banker (owner of a bank) who has to choose between long run and short run success. Normally these are conflicting objectives. A maximal immediate success may well reduce long-run gains. This is so because such a strategy implies ruthless behaviour against customers and partners adverse to a long-run relationship. A lack of fair dealing may well serve short-run goals and endanger long-run success. Business friends will not accept this, and not cooperate in future.

Moreover it is not reasonable to use every present chance. Waiting for future opportunities is often the better choice. The economic principle requires the best choice for the long run and not a maximum choice of the present period. On the whole it is not optimal to use all possibilities at once. An optimal intertemporal allocation will avoid myopic depletion of resources. Suppose a banker tries to maximize immediate profits, then he will be forced to postpone long run chances. If he aims at long-run profit maximization he must not use every opportunity to earn quick money. We depict the situation by a diagram (Figure no. 2). Simplifying the argument we distinguish only two periods, the "short run" and the "long run" (profit discounted for the present period). The relationship between the short-run and the long-run profits is represented by the curve AA'. The curve is supposed to be monotonously decreasing and convex. That means taking care for the future should not prevent from making the best out of present chances: A trade-off is asked.

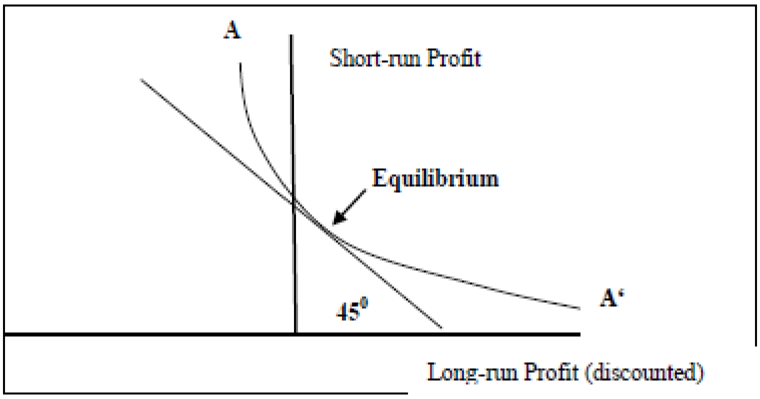

Figure no. 2: Short run versus long run profits

The owner of the bank, say the principal, will decide according a trade-off between short-run and long-run profits. The optimal choice is given by a situation where the marginal discounted long –run profit equals the marginal short-run profit. Any additional immediate gain is compensated by long-run losses. In Fig. 1 this is the point where the AA'-curve has a gradient of 45o, the equilibrium point. The AA'-curve is not precisely known. The judgment of the decider will vary in time and space. An objection to the arguments may that it is not very probable that the description given here depicts the way of thinking either of the principal or the agent. In some way or other, however, they both have presentations of the relationship in their mental maps that are more or less equivalent to the model here. Of course, the agents have no concise idea of the future. They have, however, some expectations, and they must have. These, of course, are widely influenced by soft factors. If they no view of the future situation they could not plan at all. The ideas they have may be wrong, and this was obviously so in the time before the crisis but they did exist.

The principal is usually a corporation that acts by employees, say agents (Eisenhardt K., 2005). Hence we have a principal-agent problem. The interests of the agent need not coincide with that of the principal. Indeed, if there are bonuses paid for the short-run period the agent will have a bias for immediate gains and decide for a point left of the equilibrium point. So the long run profits are depleted more than the short-run profits increase. Reasons for a short-run preference are the following: The risks of the bank are common risks of the principal and the agent as far as both are motivated by profits, provided bonuses follow the short-run gains. Beyond these risks the agent bears additional imponderables. The future is uncertain. On the one hand the agent's personal position may change; on the other hand the agent is not accountable for losses of the bank in the long run. Under these circumstances it is perfectly rational for the agents to choose a point left of the equilibrium point. The principals are responsible for conditions that guide the behaviour of agents and finally pay a lot of money for it. Suppose for simplicity that the shape of the AA'-curve is given. A more optimistic view of the future could then be expressed by a shift of the curve to the right: AA'→BB'(Figure no. 3).

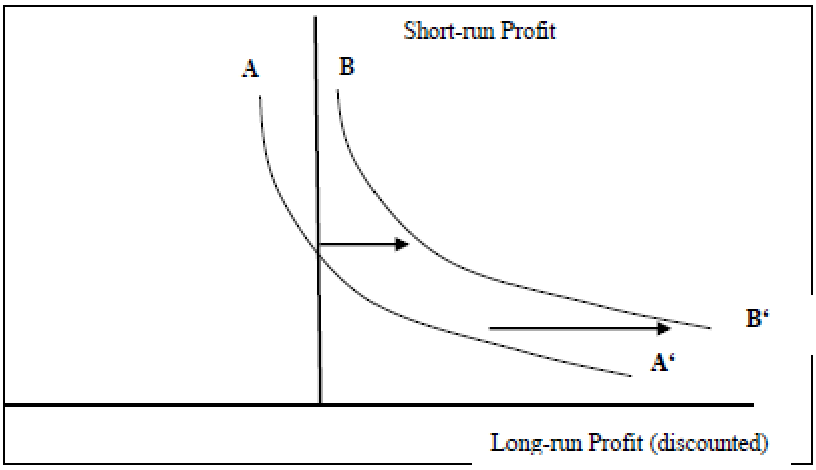

Figure no. 3: Shift of long run versus short run profit

The optimal point, too, is shifted to the right which means that the short-run policy, and therefore the corresponding short-run profit as preferred by principals is unchanged. The question is whether agents with a bias to high short-run profits will be influenced by expectations. Agents usually want to have success. Success is good for their reputation and their professional future. Therefore they certainly want to avoid future losses or poor profits for their principal. Although this is true the interests of agent and principal are not identical. Bonuses will cause agents to perform a trade-off between their short-run interests and their principal's long-run interests. Now it is possible to assess the effects of expectations. An agent who expects a favourable business climate will be inclined to strongly stress the present opportunities even if long-run profits are alleviated. This argument stays valid for situations where the agent recognizes some risks for the future. Here it is quite natural to exploit the chances of today. Human nature is corrupt in a very subtle way. Why should an agent not use the chances of a bull market where his colleagues and competitors show optimism – even if he has some doubts?

Boom and depression have a psychological dimension. A single agent can hardly withstand the challenge of such phases of economic activity. The result of this reasoning: Agents are more prone to use the chances of the day (neglecting long-run disadvantages) than principals that act in their own responsibility. Corporations are therefore more readily trapped into the fallacies of a boom than small and medium-sized businesses. The discrepancy between the interests of shareholders (not only of banks) in their role as principals and managers as their agents is striking. An explanation for this phenomenon is given by the fact that shareholders and managers are not partners that negotiate some contract between them. Actually the contract is negotiated between agents in the role of the principal since a corporation is not able to decide and other agents who run the business. The contract between principal and agent is therefore a contract among agents. Agents have an interest to negotiate favourable conditions for their class.

Conclusions

Which conclusions can we draw from foregoing considerations? It is possible to take care that some of the obvious shortcomings of the financial system will be removed. The state should set a few convincing rules and otherwise not intervene into the market. The state is a bad banker. In Germany mainly the public banks were hit by the crises. Their behavior should therefore not be made a benchmark. There are many possibilities to achieve what is required. It should be made sure that the following principles will prevail:

- The practice of bonuses ought to be reformed such that managers become motivated by long-run profits. Managers of corporations are in the position of entrepreneurs. Successful entrepreneurs may expect high profits. This should be true for successful agents in the role of entrepreneurs, too. The function of entrepreneurs, however, also is to bear risks. He who receives high remuneration is able to take over risks. Bonuses are not too high but have taken on the character of riskless rents.
- The information of the public must be improved. The rating system should be extended. More institutions should be periodically checked, more detailed results should reach the public. Securities must be analysed with respect to the connected risks.
- Banks must be obliged to give full information to their customers. This is to be required especially with respect to the modern style bonds with hidden risks that

are new in history. It is necessary to develop rules for accountancy of the bank if information had been deficient.

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